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The author examines the law regarding tax treatment of promises to pay in the future and finds it in a state of confusion. After discussing the inequities arising from the differing treatment accorded cash and accrual basis taxpayers the author suggests a number of changes in the tax treatment of installment sales and annuities given in exchange for property. The author also makes suggestions for simplification of the concept of cash equivalence.

I. Introduction

At some point tax complexity leads to a breakdown of the self-assessment system. Some believe that with respect to the tax consequences of promises to pay in the future the stress limit is perilously close—if, in fact, it has not already been reached.[1] The legal test for determining the so-called "cash equivalence" of such promises has never been clearly articulated. In addition the ultimate tax consequences of such a promise cannot be determined without resolving complex marketability and valuation questions.

In most cases it is the cash basis taxpayer who has to cope with these complexities. Although the term, cash basis, gives a contrary implication, the receipt of property as well as money will result in a realization of income for the cash basis taxpayer. A promise to pay in the future does not fit neatly into either the category of property or cash but may, depending on the form of the promise, have some

1. *See, e.g.*, Ginsburg, *Tax Simplification—A Practioner's View*, Nat'l. Tax J. 317 (1973).

attributes of both. The determination of what attributes of the promise will cause its receipt to be treated as a realization of income is referred to as a question of cash equivalence—it could just as properly be termed a question of property equivalence.

The accrual basis taxpayer, on the other hand, realizes income at the time when an obligation to pay becomes fixed and the amount of that obligation can be reasonably ascertained.[2] The receipt of a bare promise by the accrual basis taxpayer frequently will satisfy these two requirements. There are occasions, however, where the receipt of a promise to pay in the future will precede the events which fix the right to receive payment. Equating the receipt of the note with the receipt of cash will result in a realization of income for the accrual basis taxpayer. Even accrual basis taxpayers cannot defer income beyond receipt.[3] More importantly, there is authority for treating all obligations for future payment received in connection with sales of real property and casual sales of personal property in a uniform way regardless of the taxpayer's method of accounting.[4] Therefore, the development of the concept of cash equivalence for promises to pay in the future can be significant to the accrual basis taxpayer as well as the cash basis taxpayer.

Some clarification and simplification of the cash equivalence doctrine may be on its way. In *Warren Jones Co. v. Commissioner*,[5] the Ninth Circuit interpreted section 1001(b) of the Internal Revenue Code[6] as requiring all rights to future payment (even those not evidenced by a separate promissory note or other indicia of cash equivalence) to be realized by the cash basis taxpayer to the extent of the fair market value of the promise.[7] The most dramatic impact of this decision occurs in situations where the taxpayer sells a capital asset in return for deferred payments and section 453 installment

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2. Treas. Reg. § 1.446-1(c)(1)(ii) (1957).

3. Schulude v. Commissioner, 372 U.S. 128 (1963). In this case the receipt by an accrual basis taxpayer of a negotiable note was equated with a cash receipt and was held to constitute gross income. The recipient of the note had not yet performed the services promised and absent the delivery of the note there would have been no accrual or income.

4. Treas. Reg. § 1.453-6(a) (1977): *But see* Western Oaks Building Corp., 49 T.C. 365, 372 n.4 (1968).

5. 60 T.C. 663 (1973), *rev'd*, 524 F.2d 788 (9th Cir. 1975).

6. I.R.C. § 1001 (b) provides: "[t]he amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of property (other than money) received." This is the provision under which gains from the sale of real property and casual sales of personal property are computed.

7. 524 F.2d at 788, 792 (9th Cir. 1975).

reporting is either not available or not elected. Not only does the seller have an immediate realization to the extent of the fair market value of the obligation for future payments but, in addition, there is a termination or closing of the sale for purposes of characterization. This means that when the seller receives future payments the tax on those payments will be determined without reference to the character of the sale. The income portion of such receipt (the difference between the face amount of the obligation and the fair market value) will be taxed as ordinary income regardless of the capital nature of the asset. For example: if a capital asset having a tax basis of $20,000 is transferred in return for a promissory note with a face amount of $40,000 and a fair market value of $30,000 the fair market value would be an immediate realization and the $10,000 of capital gain ($30,000 fair market value minus $20,000 basis) would be subject to immediate recognition. The remaining $10,000 ($40,000 face amount minus $30,000 fair market value) if received would be ordinary income.

The theory underlying the government's position in *Warren Jones Co.* is not clear but it appears to be that the term "property" as used in section 1001(b) includes all obligations for future payment which have an ascertainable fair market value including those obligations which do not meet the requirements of the cash equivalence tests.[8] The court's acceptance of the government's position is based on the legislative history of sections 1001(b) and 453. The court attached great significance to the changes made in the language of section 202(c) [predecessor of section 1001(b)] by the Revenue Act of 1924.[9] The following language was eliminated: "On an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a *readily realizable market value* . . . ."[10]

The above language was replaced by what now appears as the present section 1001(b). Such a change hardly seems conclusive but the court determined that Congress did intend by the change to treat all obligations for future payment as a realization, and when, in 1926, Congress enacted the installment sales provisions it was

8. Warren Jones Co., 524 F.2d 788, 791 n.6 (9th Cir. 1975).

9. Rev. Act of 1924, ch. 234 § 203, 43 Stat. 256. (now I.R.C. § 1001 (6)).

10. Rev. Act of 1921, ch. 136 § 202(c), 42 Stat. 230. (now I.R.C. § 1001(b) (emphasis supplied)).

motivated by a desire to alleviate the hardship of immediate recognition resulting from the 1924 amendment. In any event, it is clear from the legislative history that as early as 1928, and probably earlier, Congress was aware of consistent Treasury policy to treat all obligations received in property transfer cases as a realization. In fact, in 1928, at the time it proposed an increase in the allowable initial payment for installment reporting from 25% of selling price to 40% of selling price, the Senate Finance Committee commented as follows:

> It has been suggested, particularly in connection with such installment sales sales transactions, that in lieu of the increase of the 25 per centum limitation, gain or loss should not be recognized on receipt of installment obligations or other property if no fair market value is determinable therefore with reasonable certainty by the application of standards customarily accepted in business practice. This suggestion involves altering the consistent practice of the Treasury Department of finding a fair market value of property in all cases where there is an ascertainable value. This committee has recommended no change in the existing law as to these matters. . . .[11]

The legislative history supports the position that Congress intended that ascertainable market value of promises to pay in the future, and not cash equivalence, control realization in section 1001(b) transactions.

Although no definition of cash equivalence would be unanimously accepted, there is general agreement that the most important factor in determining cash equivalence is marketability at a reasonable discount.[12] This was the standard applied by a majority of the Tax Court in *Warren Jones Co.*, where the Tax Court concluded that the substantial difference between the fair market value and the face amount of the obligation to pay in the future negated cash equivalence and, therefore, the receipt of the obligation was not a realizable event.[13] The Ninth Circuit reversal of the Tax Court

11. S. REP. No. 960, 70th Cong., 1st Sess. 22-24 (1928).

12. Cowden, Sr. v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961), *on remand*, 30 T.C.M. (P-H) ¶61, 229 (1961); Nina J. Ennis, 17 T.C. 465 (1951); Harold W. Johnson, 14 T.C. 560 (1950).

13. The fair market value was approximately 50% of the face value. The fair market value was determined by reducing the discounted value by a required security deposit of $41,000 which was in a savings account assigned as security to the purchaser of the obligation. Warren Jones Co., 60 T.C. 663, 667 (1973).

in *Warren Jones Co.* should not be interpreted as a rejection of the Tax Court's standards for determining cash equivalence. The Ninth Circuit indicated that the result it reached would be the same whether it was based on a theory that cash equivalence is not required under section 1001(b), or a theory that every obligation with a fair market value is the equivalence of cash.[14] The court, therefore, concluded that there was no need to distinguish between them. The author, however, would strongly urge the adoption of the former theory.[15]

The first step in clarifying the concept of cash equivalence is to segregate section 1001(b) transactions, casual sale of personal property and all sales of real property, from other transactions in which obligations for future payments are obtained. The concept has been adulterated because of the Service's zeal in attempting to reduce the opportunities for prolonged deferral in section 1001(b) transactions. The opportunity for deferral of gain in section 1001(b) transactions results from the use of the open transaction (sometimes called deferred-payment) method of reporting gain. Under this method no gain is reported until the seller receives cash payments in excess of the basis of the property transferred.[16] The Service's goal is to limit such reporting to transfers where the obligation for future payments has no ascertainable market value. Furthermore, the Service's position is that only in rare and extraordinary cases will an obligation be considered as having no fair market value.[17]

More extensive use of the open transaction method has been justified, however, on a theory that a bare obligation of a buyer to pay in the future is not property and, unless the obligation has attributes such as ready marketability, it is not the equivalent of cash. This cost recovery method of reporting, which permits the cost basis of the promise to pay to be recovered before ordinary income is realized is available only where the obligation is considered speculative.[18] Thus gain cannot be computed under section 1001(b) and is necessarily deferred until the payments received on the obligation

14. Warren Jones Co. 524 F.2d 788, 791 n.6 (1975). Judge Tannenwald, in his dissent in the Tax Court, advances a different theory in making readily marketable at any discount the only test.

15. This was the theory adopted by Judge Quealy in his dissenting opinion in the Tax Court, 60 T.C. 663, 673-74 (1973).

16. Treas. Reg. § 1.453-6(a)(2) (1958).

17. *Id.*

18. Morton Liftin, 36 T.C. 909 (1961), *aff'd*, 317 F.2d 234 (4th Cir. 1963).

exceed the basis of the transferred property. In a word, the transaction remains "open."

Conversely, if a bare promise for future payment constitutes property as that term is used in section 1001(b), then the sale transaction is immediately "closed" on receipt of such obligation. The Service has contended with singular success that this "closing" has the concomitant effect of insulating the actual receipt of the payments promised and, therefore, the income from such receipt is characterized and reported without reference to the sale.[19] The tax treatment for the receipt of payments is then the same as that applied to payments on obligations acquired for cash.[20] Each payment is apportioned between return of basis and ordinary income.[21]

A persuasive argument can be made under the rationale of *Arrowsmith v. Commissioner*[22] that income resulting from future payments should be characterized by reference to the closed property transfer. In *Arrowsmith* shareholders who had in an earlier year reported a long term capital gain on receipt of a liquidation distribution were limited to long term capital loss treatment when a portion of the liquidation distribution had to be repaid to the corporation. The Supreme Court noted the relationship of the repayment to the liquidation distribution[23] and held that merely characterizing a later event by reference to an earlier event did not necessarily violate the sanctity of the annual accounting period.[24] The same kind of indulgence could be exercised with respect to receipt of payments on obligations obtained in closed property transfers. Unfortunately the *Arrowsmith* doctrine has always been limited to deduction cases and this restriction seems too well rooted in the tax law to be changed by court decision.[25]

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19. Darby Investment Corp., 37 T.C. 839 (1962), *aff'd*, 315 F.2d 551 (6th Cir. 1963); Shafga Realty Corp., 8 B.T.A. 283 (1927).

20. Herbert S. Witte, 41 T.C.M. (P-H) ¶ 72, 232 (1972), *rev'd on other grounds*, 513 F.2d 391 (D.C. Cir. 1975).

21. Osenbach v. Commissioner, 198 F.2d 235 (4th Cir. 1952); Wingate E. Underhill, 45 T.C. 489 (1966). If the obligor is a corporation or government, section 1232 of the Code would be applicable and a portion of the income could qualify for capital gain. The formula for the proration to bases is: F.M.V. of note ÷ Face amount of note.

22. Arrowsmith v. Commissioner, 344 U.S. 6 (1952).

23. *Id.* at 8.

24. *Id.* at 9.

25. *See* Rabinowitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts or Payments*, 28 TAX L. REV. 85, 101 (1972).

II. Section 453 Installment Sales Reporting—An Alternative

Where section 453 of the Code is elected the obligation of the buyer is valued at face, regardless of actual fair market value, for purposes of computing the realized and recognized gain.[26] The gain is characterized by reference to the sale of the property and no income is reported until an actual payment is received. The income reported on receipt of payment is that proportion of the payment which the total gain bears to the total price.[27] Thus with respect to the characterization of gain, the tax is the same under section 453 installment reporting as under the open transaction method of reporting. But, unlike the open transaction method of reporting where gain is deferred until the basis is recovered in full, section 453 provides for ratable recognition of gain.

Obviously many taxpayers will continue to elect section 453 installment reporting rather than risk rejection of the open transaction method of reporting the gain. Such a calculation of risk is made on the assumption that adoption of the open transaction method forecloses a later election of section 453. This assumption appears to be inaccurate. Neither the statute nor the regulations contain a specific time requirement for the election. The Commissioner announced twelve years ago[28] that a revision of the regulations was forthcoming, but it is still long overdue. It is clear, however, that reporting gain by a method that is inconsistent with installment reporting forecloses a later election to report the gain under section 453.[29] Nevertheless, at least one case has held that a taxpayer can elect to report the gain under section 453 notwithstanding the fact that the gain was initially erroneously reported as an open transaction.[30] The court reasoned that an invalid election (in this case erroneous treatment as an open transaction) is tantamount to no election; the gain must be recalculated in any event and, therefore, the court allowed the taxpayer to elect the installment method. Although this reasoning is suspect, it has apparently influenced the

26. Frizzelle Farms Inc., 61 T.C. 737, 741-42 (1974), *aff'd per curiam*, 511 F.2d 1009 (4th Cir. 1975).

27. I.R.C. § 453 (a)(1).

28. R.L.C. Rul. 65-297, 1965-2 C.B. at 152 (revoking Rev. Rul. 93, 1953-1 C.B. at 92).

29. Albert Vischia, 26 T.C. 1027 (1956); Strauss v. Commissioner, 33 B.T.A. 855 (1935), *aff'd*, 87 F.2d 1918 (2d Cir. 1937).

30. Mamula v. Commissioner, 346 F.2d 1016 (9th Cir. 1965). *Contra*, George E. Frietas, 35 T.C.M. (P-H) ¶ 66,105 (1966).

Commissioner. In *Warren Jones Co.*, the Commissioner conceded the validity of a section 453 election which was conditioned on the rejection of open transaction reporting.[31]

The well informed taxpayer will not be impelled by this precedent to forego additional deferment under open transaction reporting. He will simply adopt the open transaction method of reporting and make a conditional section 453 election in the year of sale. *Warren Jones Co.* appears to have no *in terrorem* effect.

Of course, uniform acceptance of the Ninth Circuit's interpretation of section 1001(b) would virtually bring an end to the prolonged deferral of gain. All sales of property whether casual or in the regular course of business would be subject to computation either under section 1001(b) or the accrual method of accounting. Virtually all regular course of business sales of personalty would be inventory sales and gain would be realized immediately under the mandatory accrual method of accounting by valuing all buyer obligations at face.[32] Casual sales of real or personal property will be subject to the gain computation rules of section 1001(b) whether the taxpayer is on the accrual or cash method of accounting.[33] Under section 1001(b) promises for future payment would be regarded as property and realized to the extent of fair market value even though the seller was on the accrual method. In effect, the method of accounting of the seller has no significance in section 1001(b) property transfers because section 1001(b) supplies the method for computing gain.

At first blush, dealer sales of real property for a promise to pay in the future would appear to permit a third alternative for the computation of gain. Even where sold by a dealer, real property is not classified as inventory[34] so that gains from real estate sales are not required to be computed under the accrual method of account-

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31. Warren Jones Co., 60 T.C. 663, 666 (1973).

32. Treas. Reg. § 1.446-1(c)(2) mandates the use of accrual accounting where the use of any inventory is necessary. I.R.C. § 471 requires inventories in most mercantile, manufacturing, wholesale or retail sales businesses. Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 185 (1934) and First Savings and Loan Assoc., 40 T.C. 474, 487 (1963) make it clear that in regular course of business sales accrual basis taxpayers value obligations for future payment at face.

33. *See* S. SURREY & W. WARREN, FEDERAL INCOME TAXATION 653-54 (ed. 1960); Comment, *Cash Equivalence*, 22 U.C.L.A.L. REV. 219, 225 n.6 (1974).

34. O.D. 848, 4 C.B. 47 (1921); Atlantic Coast Realty v. Commissioner, 11 B.T.A. 416 (1928).

ing. A logical case also could be made for permitting the real estate dealer to compute gain without reference to section 1001(b). It is an acknowledged tax principle that the computation rule of section 1001(b) yields to the seller's regular method of accounting for regular course of business sales of stock in trade.[35] Therefore, it may appear that by electing the cash method of accounting the real estate dealer could not only avoid the closing of the sale under section 1001(b) but also, as a cash basis taxpayer, report the gain under the open transaction method. But once again, history rather than logic and the exception rather than the general rule controls. The legislative history of section 1001(b) indicates that Congress intended that all gains from real property sales, whether casual or in the regular course of business, be computed under section 1001(b).[36]

Pursuit of the proverbial "bottom line" to *Warren Jones Co.* leads to the following conclusions: (1) fair market value and not cash equivalence is the *vel non* of realization for buyer obligations to pay in the future obtained in connection with any sales of real property or any casual sales of personal property. The Service will continue to take the position that fair market value can be ascertained except where the circumstances are extraordinary. Thus market value will be ascertainable except where the obligation to pay or the amount to be paid is contingent. (2) Even where such sales are made by the accrual basis taxpayer, the realization will be computed by valuing the obligations at fair market value rather than face value. Section 1001(b) (under the *Warren Jones Co.* interpretation) appears to leave no room for varying the treatment regardless of the taxpayer's method of accounting.[37] The Service will have to discontinue using a double standard, i.e., advocating the independent operation of section 1001(b) for a cash basis taxpayer while at the same time contending that the accrual basis taxpayer's

35. *See* discussion in S. SURREY AND W. WARREN, *supra* note 33.

36. S. REP. No. 398, 68th Cong. 1st Sess. § 202(c) at 13 (1924). In addition, the statutory structure of I.R.C. section 453 which treats casual sales of personal property and all sales of real property under subsection (b) and personal property sold in the regular course of business under subsection (a) is a similar indication.

37. The Service at present takes the inconsistent position that cash basis taxpayers are subject to section 1001(b) computation but that 1001(b) is not the computation rule applied to accrual basis taxpayers. The courts have supported this position. Western Oaks Bldg. Corp., 49 T.C. 365, 373-75 (1968); First Savings and Loan Assoc., 40 T.C. 474 (1963).

realization is computed by valuing the buyer's obligation at the face amount.

Litigation will probably continue until these legal principles are uniformly accepted or rejected since the fair market value of the obligation will control not only the amount of gain or loss from the sale but also the potential amount of ordinary income from receipt of payments on the obligations. For example, where highly appreciated capital gain property is exchanged for an obligation which has a fair market value that is lower than the basis of the property exchanged, the anomalous result would be a capital loss followed by a substantial realization of ordinary income.[38]

All of this potential litigation would be avoided if agreement could be reached on reform. A distinguished tax practitioner[39] advocated such reform at the NTA-TIA Tax Symposium held two years prior to the Ninth Circuit opinion in *Warren Jones Co.* The essence of his proposal is still the key to sensible reform: all sales of real property and all casual sales of personal property for a price payable in whole or in part by fixed future payments would be reported under a more inclusive statutory provision for installment reporting unless the seller elects immediate realization of the full face amount of the buyer obligation. This proposal could be statutorily implemented by: (1) eliminating the "two payment rule"[40] and the year of sale thirty percent payment limitation from section 453; (2) reversing the election procedure so that the taxpayer elects out of, rather than into, section 453 installment reporting; and (3) imposing as the cost of such election immediate realization of the full face amount of the obligation to pay in the future.

In those cases where the total amount realized cannot be determined at the time of sale because all or some of the payments are contingent, any gain that can be determined including gain which is only remotely contingent, should be reported under section 453 installment reporting except where the taxpayer elects to report

38. This could happen frequently if the Tax Court, when ascertaining the fair market value, insists on reducing the amount of a required security deposit from the going discount rate.

39. See Ginsburg, *Tax Simplification: A Practioner's View* 26 NAT. TAX. J. 317 (1973). The author has expanded and modified his original proposal. See Ginsburg, *Proposal for Structural Reform* 30 TAX. L. REV. 471 (1975).

40. The Tax Court interpretation is that installment sales require at least two payments. Baltimore Baseball Club, Inc. v. United States, 481 F.2d 1283 (Ct. Cl. 1973); 10-42 Corporation, 55 T.C. 593 (1971).

such gain immediately. But any gain which cannot be determined at the time of sale should be treated as resulting from an open transaction whether the taxpayer is on the cash or accrual method.[41]

A different result should occur where the total gain on the sale cannot be determined at the time of sale because the buyer's obligation is in the form of an annuity (a promise to pay a specific sum annually, or in more frequent intervals, for the life of the seller). Separate tax treatment of annuities is warranted because: (1) there is a market place where values are fixed for annuities issued in ordinary course by commercial enterprises; (2) some approximation of the value of all annuities, commercial and private, can be made by the use of mortality tables in conjunction with projections for the earning power of money;[42] and (3) there is a separate legislative scheme for taxing annuities.[43] In situations where the obligor has not, at least from time to time, issued other annuity contracts, the methods for valuation specified above become quite speculative since other factors, including the likelihood of full performance, must be considered in determining whether the value of the private annuity can be sufficiently ascertained for purposes of immediate recognition of gain or loss. Where there is a determination that the private annuity cannot be adequately valued, the sale cannot be closed and the reporting of the gain will have to be deferred.[44]

The need for additional clarification of the guidelines for determining whether the receipt of a private annuity results in immediate recognition or permits a special kind of deferred reporting will be apparent after a brief exposure to their chronological development.

The House version of the 1954 Code contained a specific provision for property transfers in exchange for a private annuity. This provision, which was later deleted by the Senate Finance Committee provided:

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41. Permitting the accrual basis taxpayer to report on the open transaction method complies with the tax principle that the accrual basis taxpayer should be treated as a cash basis taxpayer where the receipt of property or money precedes the time for realization under the accrual method. The time for realization under the accrual method would not arise until the contingent event occured. *See* Goetz Gasket and Packing Co., Inc., 24 T.C. 249 (1955); *See also* note 3 *supra*.

42. For discussion of value *see* Estate of Lloyd G. Bell, 60 T.C. 469 (1973).

43. I.R.C. § 72.

44. *See*, Burnet v. Logan, 283 U.S. 404 (1931); J. Darsie Lloyd, 33 B.T.A. 903 (1936).

> If a taxpayer exchanges property (other than money) for a consideration which includes an annuity contract, the value of the annuity contract computed without regard to the financial condition of the obligor shall be included in the amount realized on such exchange. Such value shall be deemed the amount of premium and other consideration paid for purposes of section 72.[45]

The intent of this bill was to change the effect of the case law which at that time permitted the seller on receipt of an unsecured private annuity to defer the recognition of the gain realized on the sale and to have his tax position governed largely by the annuity rules of section 72 of the Code.[46] The exclusion ratio[47] under section 72, which is used to determine what portion of each annuity payment constitutes a return of investment, was to be calculated by treating the fair market value of the property transferred as the investment in the annuity contract. The gain from the property sale, the excess of the fair market value over the basis of the property transferred, was not reported until the aggregate amount of the exclusion ratio portion of the annuity payments exceeded the basis of the property transferred—a type of open transaction reporting.

In Revenue Ruling 69-74[48] the Service took the position that: (1) the gain realized on the sale of property in return for a private annuity is computed at the time of the sale by treating the value of the annuity as the amount realized; (2) the excess of the fair market value of the transferred property over the value of the annuity constitutes a gift for gift tax purposes, except where the transaction is at arm's length; (3) the seller's investment in the annuity for purposes of computing the exclusion ratio under section 72 of the Code is the basis of the property transferred to acquire the annuity; (4) the gain realized on the sale should be reported ratably over the period of years measured by the life expectancy of the seller; and (5) the portion of the annuity payment which exceeds the exclusion ratio plus the portion reportable as gain is reported as ordinary income.

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45. Section 1241 of Internal Revenue Code of 1954, as reported in H.R. 8300, 83rd Cong., 1st Sess. (1954).

46. Commissioner v. Estate of Kann, 174 F.2d 357 (3rd Cir. 1949); Hill's Estate v. Maloney, 58 F. Supp. 164 (D.N.J. 1944); J. Darsie Lloyd, 33 B.T.A. 903 (1936).

47. Exclusion ratio is the quotient obtained by dividing the seller's investment for the contract by the expected return under the contract.

48. 1969-1 C.B. 43.

The Ruling drastically altered the previously accepted treatment.[49] It changes not only the method of reporting the gain on the sale from the open transaction method to installment reporting, it also reduced the exclusion ratio. The exclusion ratio remains applicable after the seller has reached his life expectancy, the point where all deferred sales gain has been reported. Thus the reduced exclusion ratio has the effect of increasing the amount of ordinary income to be reported by a seller who lives beyond his life expectancy. Six Tax Court judges, who dissented from the majority in a 1973 opinion which required immediate recognition of a secured private annuity, approved in principle both the method for computing realized gain and the installment reporting prescribed by the Ruling.[50] The same judges disagreed, however, with the Ruling's position on calculation of the exclusion ratio. They determined that the exclusion ratio should be calculated by treating the value of the annuity at the time of the sale as the investment in the annuity contract.[51]

It must also be noted that in a 1972 regulation, which contains a tax computation for a bargain sale of property to a charity in return for an annuity, the value of the annuity at the time of sale is treated as the investment in the annuity.[52] This regulation may or may not reflect a change in the Service's position set forth in Revenue Ruling 69-74. If a change was intended the present Service position deserves endorsement. It is reasonable to require that realized gain from the property transfer be computed on receipt of the annuity by approximating its value. Otherwise there would be no way to separate gain income from annuity income. Although many would argue that the rejection of cost recovery reporting in favor of ratable reporting of that gain is without judicial or legislative support, such ratable reporting is reasonable and well within the spirit of the aforementioned reform proposals.

The Service accedes to ratable reporting only where the annuity can be classified as private rather than commercial or quasi-commercial. To pass muster as a private annuity under the test set forth in Revenue Ruling 62-136,[53] the obligor's experience cannot reveal any regular or irregular pattern of issuing annuities. The

49. Rev. Rul. 239, 1953-2 C.B. 53. (revoked by Rev. Rul. 69-74, 1969-1 C.B. 43).
50. Estate of Lloyd G. Bell, 60 T.C. 469 (1973).
51. *Id.* at 476.
52. Treas. Reg. § 1.1011-2(c) Example (8) (1972).
53. 1962-2 C.B. 12.

issuance of the annuity must be an isolated event. Interestingly, 1972 Regulation 1.1011-2(a)(4) expressly provides for private annuity treatment where a charity promises to pay only the transferor, or the transferor and a designated survivor, a nonassignable annuity. Since the regulation makes no reference to the experience or future intentions of the charity with respect to issuance of annuities it is not clear whether this constitutes a change in the position set forth in Revenue Ruling 62-136.[54]

Although the regulation referred to above does not deal with the effect of securing the annuity, the Tax Court's position in the past has been that the seller's gain must be reported immediately on receipt of a secured promise to pay an annuity.[55] Obviously the security reduces the uncertainty of performance, and, therefore, has a direct effect on the marketability of the promise. The Tax Court seems to regard the risk of performance as the controlling issue in determining whether to treat the sale as "closed" or to permit deferred reporting.[56] The court seems to be misplacing its focus. There is nothing really unique about the risk of performance in annuity cases. The unique feature in annuity cases is the contingency of death of the annuitant. It is this contingency that restricts the marketability of the annuity and causes valuation to be speculative at best.[57] It is this same contingency which makes section 453 installment reporting inappropriate.

Nevertheless, on balance one must conclude that it would take little more than clarification to bring simplicity and predictability to the private annuity transaction. This could be accomplished by a slight modification of Revenue Ruling 69-74. Such a modification should incorporate the following principles: (1) except where the seller takes his property to the commercial market to acquire an annuity, the gain should be reported under the ratable reporting method set forth in Revenue Ruling 69-74. (2) Such reporting should be permitted whether the promise is secured or unsecured and regardless of the annuity experience of any obligor other than a full-fledged commercial entity. (3) Except where the circumstances in-

54. Rev. Rul. 62-136, 1962-2 C.B. 12.

55. *See* Fehrs Finance Co. v. Commissioner, 487 F.2d 184, 189 (8th Cir. 1973); Estate of Lloyd G. Bell, 60 T.C. 469 (1973). *See also* Haley, *The Application of Section 1001 to Preferred Payment Sales of Property*, 28 TAX LAW. 303 (1975).

56. *See*, J. Darsie Lloyd, 33 B.T.A. 903 (1936).

57. Estate of Lloyd G. Bell, 60 T.C. 469 (1973) (dissenting opinion by Simpson, J.).

dicate a bargain sale of the property, i.e., where the property is transferred to a charity or a natural object of the seller's bounty, the annuity should be valued for realization purposes by reference to the fair market value of the property transferred and not the value of the annuity at date of transfer.[58]

III. Cash Equivalence

The modest reform suggested above for section 1001(b) transactions would bring predictability and simplicity to the property transfer cases. In addition, in all other transactions, it would permit the cash equivalence doctrine to develop as a uniform and manageable test of realization where obligations to pay in the future are received by cash basis taxpayers. Although tax treatment appears to vary with the subject matter of the transaction,[59] once the property transactions are set apart, common guidelines emerge for all other transactions.[60]

With the exception of section 1001(b) the Code does not treat as property a promise for future payment unless it is the promise of a third party. In that case by dealing with third party obligations the parties to the transaction are clearly manifesting an intent to treat the third party obligation as property. Where one party to the transaction becomes obligated to make a payment in the future to the other party to the transaction, there is no realization of income to a cash basis obligee unless the obligation is endowed with additional attributes called cash equivalence.[61]

The primary question of intent must be resolved before determining whether the obligation will be treated as a cash equivalent. There will be no cash equivalence if it can be established that the receipt of the promise, whatever the form, was not intended as payment but merely as evidence of the indebtedness. The primacy

58. This would be a valuation technique conparable to that in U.S. v. Davis, 370 U.S. 65 (1962).

59. *See*, Brandis, *The Treatment Accorded Promissory Notes Under the Federal Income Tax Law*, 52 N.C.L. Rev. 93 (1973).

60. It is true that with respect to promises to pay in the future for services the only test appears to be intent. *See* Treas. Reg. § 1.61-2(d)(4) (1977). In other areas intent seems to play a minimal role. Nevertheless the ultimate test for all transactions other than property seems to be intent as determined from the objective evidence of marketability.

61. Certainly the cash basis taxpayer has no income on the creation of an open account. This is the point of distinction between the cash basis taxpayer and the accrual basis taxpayer. Treas. Reg. § 1.446-1(c) (1957) (emphasis added).

of the intent test clearly emerges in transactions involving services or loans. The regulation dealing with compensation for services under section 61 of the Code states: "[n]otes or other evidences of indebtedness received in *payment* for services constitute income in the amount of their fair market value."[62] An earlier regulation refering to notes "received in payment for services and not merely as security for such payment"[63] more clearly reflected the importance of the intent test. Under the current regulation, courts still continue to retain the payment intent test.[64] Thus, where a lessor has received promissory notes for future rent the courts have looked to the parties' intent.[65] If the notes were intended as advanced payment of rents then there is immediate recognition of income. On the other hand, if the court finds that the notes are merely additional evidences of the indebtedness no income is recognized.

In the related situation where notes are received in loan transactions the Service has decided that its treatment of payments made on those notes will turn on the intent of the parties. Revenue Ruling 63-57[66] dealt with a situation where a borrower made a note to a lender in exchange for an amount of cash less than the face amount of the note. The difference between the face amount of the note and the cash advanced represented add-on interest. Where the parties had agreed that all payments on the note were to be applied first to the principle the intent of the parties governed and the Service ruled that the lender would not have to report as income any payments made on the note until it had received payments equal to the amount advanced. The intent of the parties governs even where a new note is issued to a cash basis lender for interest already due. No income is recognized unless there is an intent to receive the note as payment.[67]

Obviously the intent of the parties will be determined in large part by the objective evidence. The best evidence is the form and

62. Treas. Reg. § 1.61-2(d)(4) (1957).

63. Treas. Reg. 69, Art. 34.

64. *See, e.g.*, Segrist v. Crabtree, 131 U.S. 287 (1889); Schlemmer v. United States, 94 F.2d 77 (2d Cir. 1938); Joe W. Scales, 18 T.C. 1263 (1952), *rev'd on other grounds*, 211 F.2d 133 (8th Cir. 1954); A. Hovey-King, 19 T.C.M. (P-H) 277 (1950); Great Southern Life Ins. Co., 36 B.T.A. 828 (1937); San Jacinto Life Ins. Co., 36 B.T.A. 186 (1936).

65. *Compare*, Astor Holding Co., 11 B.T.A.M. (P-H) 1084 (1942), *aff'd*, 135 F.2d 47 (5th Cir. 1943) *with* Gates v. Helvering, 69 F.2d 277 (8th Cir. 1934).

66. 1963-1 C.B. 103, 105.

67. Joe W. Scales, 18 T.C. 1263 (1952).

nature of the obligation itself. If the promise is in the form of a note that can be freely assigned and a ready market exists where the note can be discounted at some reasonable rate, a strong inference can be drawn that the note was accepted as payment. On the other hand if the obligation is not readily tradeable at a reasonable discount a strong inference can be drawn that it was not intended as payment. Cases may exist where the actual intentions of the parties are different than the logical inferences suggested by the marketability of the promise, but the taxpayer in that case would face a substantial burden of proof which probably could not be met unless other facts about the transaction could be offered as substantiation.[68]

It is true that many factors such as the security for the obligation, the financial status of the debtor, and the conditional or unconditional nature of the liability have to be considered in resolving the question of marketability. But predictability is within tolerable levels.

If the Service in a spirit of compromise would openly acknowledge that the intent of the parties is paramount in resolving cash equivalence and agreed to challenge taxpayer treatment of such obligations only in those cases where the taxpayer claimed an intent contrary to the inferences suggested by the form and nature of the obligation, litigation would be reduced and opportunities for abuse would be minimal. Also the really difficult questions of market valuation would arise only where a ready market did not exist and then only when the taxpayer opted for the immediate realization of an obligation which was not readily tradeable.

The stage is set for meaningful and comprehensive reform. It can be accomplished without radical alteration of established legal principles since little more than agreement on the ground rules would be required.

68. Schlemmer v. U.S., 94 F.2d 77 (2d Cir. 1938).